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USDOC FOR 4530/ITA/MAC/OSA/LDROKER/ASTERN
DEPT PASS TO USTR FOR SOUTH ASIA - CLILIENFELD/AADLER
DEPT PASS TO TREASURY FOR OFFICE OF SOUTH ASIA - MNUGENT
TREASURY PASS TO FRB SAN FRANCISCO/TERESA CURRAN
DEPT OF ENERGY FOR TOM CUTLER, DCOLUMBO, MGINSBERG

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TAGS: ECON EFIN EINV ETRD EAGR EPET PREL PGOV IN
SUBJECT: THE NEW BUDGET INVESTS IN RURAL INDIA, BUT POSTPONES FISCAL CONSOLIDATION

REF: NEW DELHI 001237

¶1. (SBU) Summary. Finance Minister Pranab Mukherjee presented a rural-oriented 2009-2010 central government budget on July 6 which many say reflect his style: pragmatic, not flashy, and indifferent to market expectations. Indeed, the initial reaction of many to the budget was one of disappointment for not laying out a reform roadmap, especially in disinvestment and FDI. Dashed expectations aside, the budget did sketch out realistic growth and revenue projections and mainly responsible budget allocations. The government had to boost spending on government salaries, per the Pay Commission, and spend more on interest payments for the oil and fertilizer bonds it issued over the last three years. Where the government had discretion to spend, it focused predominantly on increasing funding for the National Rural Employment Guarantee Program and rural and urban infrastructure. The allocations represent a desire to sustain rural consumer spending in the short term while the economy continues to recover from the global crisis, while also laying the groundwork for long-term growth and productivity increases through better roads, electricity, and housing.

¶2. (SBU) Summary continued. On the revenue side, the Finance Minister proposed minimal personal income tax cuts, which have been offset by a modest expansion of the service tax net and a higher minimum alternative tax for large corporations. The central government's fiscal deficit is projected to hit an 18-year high of 6.8% of GDP, rising from 6% in the fiscal year just ended March 31. The higher deficit will require more market borrowing, which could push up interest rates, or lead to monetizing some of the debt, essentially printing additional currency, which would expand the money supply and fuel inflationary pressures. Other economists also worried that the higher deficit might endanger India's sovereign debt rating, but a Standard & Poor's spokesperson commented that the deficit was within its expectations, suggesting India's investment grade rating is safe for now. The Finance Minister's budget speech also committed to introducing the national goods and service tax (GST) by April 2010, submitting a draft new income tax code in 45 days, and restructuring the fertilizer subsidy away from producers to consumers, namely farmers who often receive only a fraction of the intended benefit. There is plenty of reform to take on in the budget, when much of the reform action will take place outside the Ministry of Finance anyway. End summary.

Budget 2009-10

¶3. (U) In a speech to Parliament , Finance Minister Pranab Mukherjee unveiled the central government's budget on July 6 for the Indian Fiscal Year (IFY) 2009-10, which began on April 1. The budget assumes a nominal GDP growth of 10% for IFY 2009-10, 12.4% in IFY 2010-11 and 13% in IFY 2011-12. Real GDP in this scenario for IFY 2009-10 would be around 6.5%, with an assumption of a normal monsoon. The budget focuses on addressing three challenges: returning to the higher growth trajectory of 9%, deepening and broadening the agenda for inclusive development, and improving the delivery and monitoring mechanisms. The budget's thrust is on infrastructure, rural development and export oriented sectors, while offering marginal relief to taxpayers to spur consumer spending.

Focus on Infrastructure Development

¶4. (U) Minister Mukherjee in his budget speech told Parliament that he intended to increase India's infrastructure spending to 9% of GDP by 2014. In this context, he proposed spending significantly higher amounts to build urban and rural infrastructure, including highways, irrigation projects, rural housing, electrification and roads. The Indian Infrastructure Finance Co. Ltd. (IIFCL) will refinance 60% of commercial bank loans made to public-private partnership (PPP) projects, which could catalyze investment up to Rs 1 trillion (roughly $21 billion). The Budget allocates Rs 129 billion ($2.7 billion) for urban infrastructure, 87% higher than a year ago, and provides Rs 40 billion (about $8.3 billion) for housing and basic

amenities to the urban poor. Mukherjee also proposes increased spending for national highway development program by 23% over IFY 2008-09 to reach $2.8 billion (Rs. 136 billion).

Social Programs Get Boost

¶5. (U) After infrastructure, the budget provides greater allocations to the flagship programs which have done well. The National Rural Employment Guarantee Scheme (NREGS) which guarantees 100 days of work to every rural household has been pledged an allocation of Rs. 391 billion ($8 billion) in IFY 2009-10, an increase of 30% over the revised estimates of IFY 2008-09. Other programs that will create rural employment and spur demand in the country include the Bharat Nirman rural infrastructure program, which had its overall allocation raised by 45%, and its component schemes such as the Acceleration Irrigation Benefit Program and Indira Niwas Yojana, a rural housing scheme, increased by 75% and 27% respectively compared to last year. (Note: The government has not provided revised IFY 2008-09 estimates for the flagship schemes, except NREGS. Instead, it has compared spending levels for the new budget to the proposals made in last year's budget, which at the time grossly underestimated spending. Such comparison creates a larger apparent increase in spending. End note.) The rural road component of Bharat Nirman also proposes to ensure full farm-to-market connectivity by upgrading more than 100,000 miles worth of existing small roads, with an investment of Rs 480 billion ($10 billion). The Pradhan Mantri Gram Sadak Yojana - a separate rural roads program - is slated to receive an increase of 59% to Rs. 120 billion ($2.5 billion). Mukherjee has also promised a 40% hike in the health insurance scheme for people below the poverty line and increased money for the Integrated Child Development Scheme and female literacy. The Rajiv Gandhi Grameen Vidyutikaran Yojana (RGGVY) program for rural electrification has seen its allocation increased by 27% to Rs. 70 billion ($1.5 billion). Spending on family and health welfare has gone up by 22% from Rs 173 billion ($3.6 billion) last year to Rs 211 billion ($4.4 billion). The government's proposed expenditure on education has increased by 11% from Rs 260 billion ($5.4 billion) last year to Rs 291 billion ($6 billion).

¶6. (U) The Finance Minister also reiterated the Congress election campaign promise to enact a National Food Security Act to ensure 25

kilograms of rice or wheat per month at Rs. 3 per kg to every family living below the poverty line in rural or urban areas. A draft Food Security Bill will be put on the website of the Department of Food and Public Distribution for public debate. No allocation has been made for this expenditure, which the Prime Minister explained in an interview was because the drafting and passage of the Act, along with identifying the targeted households, would take more than a year.

Expenditures Rise

¶7. (U) Total spending for IFY 2009-10 is estimated at Rs 10,208 billion ($213 billion), an increase of 13.3% over last year's revised spending figures. Plan (developmental) expenditure gets a major boost in the Budget, reflecting the government's commitment to accelerating the growth process. At Rs 3251 billion (approximately $68 billion), the Plan expenditure will rise by 14.9%, while non-plan expenditure is expected to rise by 12.6%. While higher plan spending is due to social sector/infrastructure spending, non-plan expenditure factors in implementation of the Pay Commission recommendations (also reflected as an increase in defense spending) and interest payments. The net borrowing program has increased from Rs 3,086 billion to Rs 3,980 billion, a 29% increase to roughly $83 billion. However, Finance Secretary Ashok Chawla clarified after the Budget Speech that, of the proposed government borrowing, only half would be raised from the market. The rest would be picked up by India's central bank, the Reserve Bank of India, implying a return to monetization of the deficit (read printing currency).

¶8. (U) The budget also provides incentives for the export sector.

The Budget provides a special fund of Rs. 40 billion ($800 million approximately) for banks and state finance corporations to facilitate lending to micro, small, and medium enterprises. The allocation for the Market Development Assistance Scheme for exporters has been increased by 148%. The existing 2% interest subsidy on pre-shipment credit to employment-oriented export sector has been extended until the end of this fiscal year (March 31, 2010).

Direct Taxes

¶9. (U) The Finance Minister has proposed modest increases in the personal tax exemptions by Rs. 10,000 ($208) and Rs. 15,000 ($312)for senior citizens (above 65 years). Women will receive an additional relief of Rs 10,000. The 10% surcharge on personal income tax has been proposed to be removed and the fringe benefit tax (FBT), which was imposing considerable compliance burden on companies, was also abolished. Removal of the FBT and the surcharge on personal income tax will cost the exchequer about Rs 100 billion ($2 billion)and Rs 50-60 billion (roughly $1-1.25 billion) respectively in the current year, which will be offset by increasing a tax on corporations and increasing the service tax net. Mukherjee also promised to simplify tax returns by coming out with a new direct tax code within 45 days for discussion to introduce a bill in Parliament in the winter session.

¶10. (U) Disappointing corporate India, Finance Minister Mukherjee made no major changes in corporate tax rates in IFY 2009-10. However, he did away with the Commodities Transaction Tax which was introduced last year, but not notified, so as to encourage trading in commodity markets. In the quest for greater equity, the budget increased the rate of the minimum alternate tax (MAT) to 15% from 10% of booked profits. Mukherjee also pledged that an alternative dispute resolution mechanism would be created within the Income Tax Department for the resolution of transfer pricing disputes. Further, the Central Board of Direct Taxes will be empowered to formulate 'safe harbor' rules for international transactions. The budget also proposes to exempt all trading in equity shares and derivatives by the National Pension System Trust from the Securities Transaction Tax (STT) to provide the necessary fiscal support to the much-needed social security system.
Indirect Taxes

¶11. (U) In the run-up to a uniform central goods and service tax (GST) rate of 8% next fiscal year, the excise duty has been doubled to 8% on many items except for bakery items, drugs, pharmaceuticals, medical equipment, and rural consumer goods. While the 2% excise tax on branded jewelry has been eliminated, it has been cut to 8% from 20% on petrol-driven trucks. Specific component of excise duty applicable to large cars/utility vehicles of engine capacity 2000 cc and above has been reduced from Rs. 20,000/ vehicle to Rs. 15,000/ vehicle. High speed diesel blended with up to 20% bio-diesel will be exempted from excise duties. Widening service tax coverage, a 10% service tax will now be applied to transport of goods by rail, coastal cargo and goods through inland water including national waterways; cosmetic and plastic surgery services; and legal consultancy services. Furthermore, shipment of goods through third party road transporters that are currently covered under the service tax regime will be exempted from service tax.

¶12. (U) Customs duties were tinkered with, although the Finance Minister chose to delay additional broad duty reductions towards ASEAN levels that the government had pursued in recent years. Additional raw material/input items(for sports goods, leather, textiles and footwear industry, all hit hard by the global slowdown) have been exempted from custom duty. The customs duty on rock phosphate will be reduced to 2% from 5%. The 5% customs duty on unprocessed corals has been totally withdrawn. The customs duty on permanent magnets used in wind operated electricity generators and mechanical harvesters for coffee plantations have been reduced to 5% from 7.5%. While the customs duty on bio-diesel has been slashed to 2.5% from 7.5%, it has been doubled for gold and silver.

¶13. (U) On technology products, set-top boxes for televisions will now attract a customs duty of 5% (earlier zero duty) but the customs duty on LCD panels is halved to 5%. In response to demands from mobile phone manufacturers, the budget announced exemption from the 4% special countervailing duty (CVD) on imports of parts and accessories for one year. On packaged or canned software, a CVD exemption will be applicable to partial value representing transfer of the right to use the software. In the health sector, the basic custom duty has been halved to 5% on influenza vaccine and nine specified life saving drugs used for the treatment of breast cancer, hepatitis-B, rheumatic arthritis, etc. and on bulk drugs used for the manufacture of such drugs; these drugs will also be exempt from CVD. The basic customs duty has also been reduced from 7.5% to 5% on two specified life saving devices used in treatment of heart conditions with full CVD exemption.

Fiscal Deficit Rises

¶14. (U) Increased spending on infrastructure and rural programs coupled with the required increase in salaries and interest payments has generated a fiscal deficit of 6.8% of GDP, compared to 6% of GDP in 2008-09. The measures taken by the government to counter the effects of the global meltdown slowdown on the Indian economy have resulted in shortfall in revenues and substantial increases in government expenditures, leading to a temporary deferment of the attainment of the Fiscal Responsibility and the Budget Management Act (FRBM)targets with respect to both. (Note: The 13th Finance Commission has been mandated to review the FRBM roadmap and its report will be released in October 2009. End note.)

Market Watchers and Business Community React

¶15. (SBU) Market investors had been looking to the budget to lay out an explicit reform roadmap (reftel) and were deeply disappointed by the Finance Minister. The Sensex market closed down 6% on July 6, the single largest drop on a Budget day, with market participants bemoaning the lack of divestment specifics or other reform measures. Dr. Brinda Jagirdar, an economist at State Bank of India, told our Mumbai consulate that the budget did not live up to the hype created during the pre-budget period. She said the Finance Minister

consulted with groups from every sector, hearing their wish list and making them feel important, but did not incorporate these expectations in the budget. She quickly added, however, that even though issues of disinvestment, FDI were not included in the budget, it did not mean that these reforms would not be carried on. Dr. Bandi Ram Prasad, President of FT Knowledge Management Co., opined that the market was focusing on one or two areas while missing that the budget had maintained its conventional priorities. The measures in infrastructure were consistent with growth objectives. He also pointed out that the budget reflected Mukherjee's "old school style without any sparks". The budget was supposed to be a document that indicated financial allocation for a year but in recent years, it had become over-glamorized, he added.

Comment

¶16. (SBU) The ruling United Progressive Alliance's (UPA) budget elicited strong opinions across the board and the wide range of reaction stems from the fact that there is still a lack of consensus about whether the economy still needs stimulus, and whether that need is worth the additional government borrowing, which risks higher inflation and or interest rates. In some ways, these divergent views reflect the wider uncertainty in the global economy today, as the whole world grapples with the biggest economic downturn since the Great Depression. Given these challenges and constraints, Finance Minister Mukherjee has delivered an overall no-frills, responsible budget that focuses on keeping economic growth above 7% in the short-term by improving consumer purchasing power, while building better infrastructure for medium-term growth. The higher fiscal deficit is a concern and the government has

currently punted to the scheduled October report of the Finance Commission to develop a medium term deficit reduction plan. However, a somewhat lower deficit is in the cards for next year because the government salary increases would have been implemented, which account for roughly one-fourth of the financing gap this year. Further deficit reductions can come from more decontrol of refined petroleum product retail prices and from restructuring the fertilizer subsidy. These, like the other reforms that have been suggested in the Economic Survey, require political consensus. And a budget cannot deliver that.

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